The 1990 Revenue Reconciliation Act:
It's Affects on the Individual Taxpayer

An Honors Thesis (HONRS 499)

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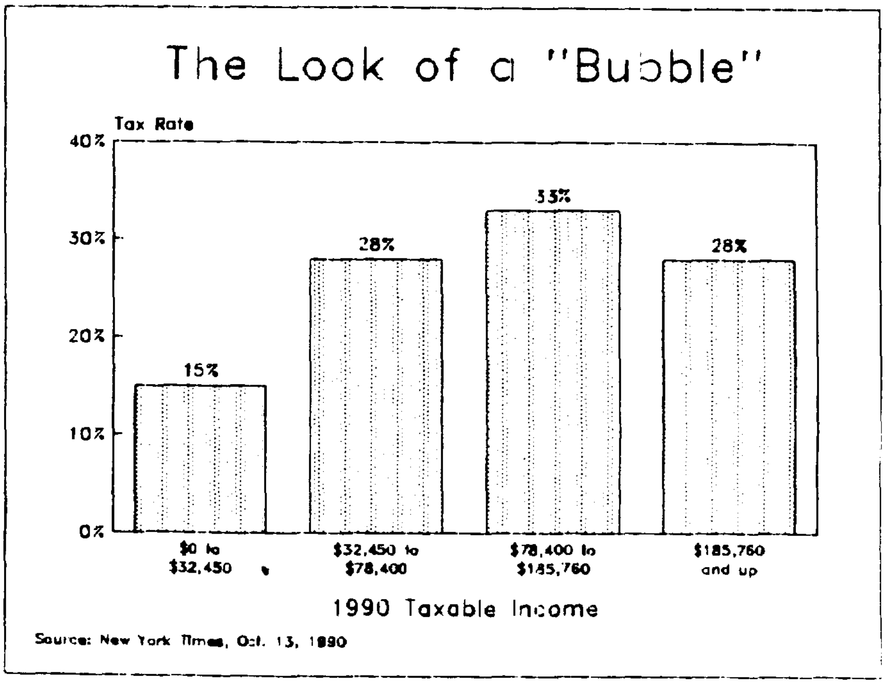
The Bubble

The bubble, brought into existence in the Tax Reform Act of 1986, will burst in 1991 as a new tax bracket is added. A compromise among lawmakers, it was an attempt to reduce the national deficit without creating a higher tax bracket. The bubble receives its name from its appearance on any graph illustrating the range of all income tax brackets. It is a 33 percent rate of taxation that applies to the amount of taxable income between $78,400 and $185,760 for couples filing jointly (Nash 10). The graph below demonstrates this point.




The bubble is considered a regressive tax because income in the range between $78,400 and $185,760 is taxed at a higher rate than income above $185,760. However, the tax is not as regressive as it appears to be. The couple whose income falls within the bubble still has the benefit of the fifteen percent marginal tax rate and a personal exemption of $2,050 in 1990. Those with taxable income over $185,760 pay a flat twenty-eight percent and are not allowed personal exemptions or the 15 percent bracket. The purpose of the bubble is to phase out the benefit of the 15 percent marginal bracket. Therefore, the effective tax rate is 28 percent for those in the upper tax bracket but only about 20 percent to about 25 percent for most of those in the bubble (Nash 10). It has been an illusion all along; although the marginal rate is lower for wealthier households, the tax paid as a percentage of income is actually higher.

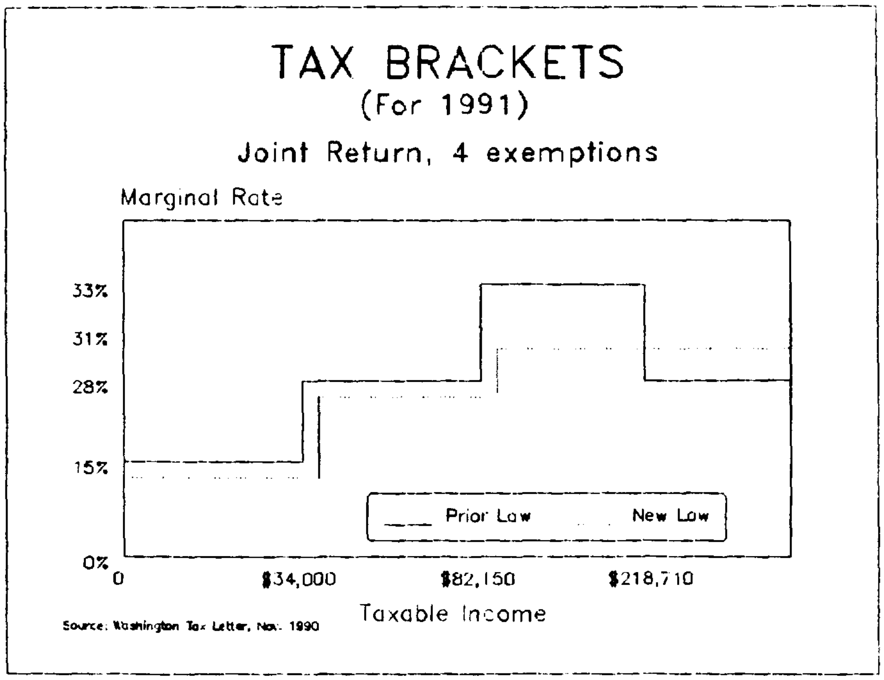
## The 31 Percent Marginal Rate Bracket

Congress has popped the bubble by removing the five percent surcharge on taxable income from $78,400 to $185,760 and adding a 31 percent bracket in the Revenue Reconciliation Act of 1990, effective for January 1, 1991. The new marginal tax brackets are as follows:

| | 15% | 28% | 31% |
|---|---|---|---|
| Single | $0 to $20,350 | $20,350 to $49,300 | Over $49,300 |
| Married Filing Joint/ Surviving Spouse | $0 to $34,000 | $34,000 to $82,150 | Over $82,150 |
| Heads of Households | $0 to $27,300 | $27,300 to $70,450 | Over $70,450 |
| Married Filing Separate | $0 to $17,000 | $17,000 to $41,075 | Over $41,075 |

Source: Update for West's Federal Taxation, 1991 Editions

The graph below compares the marginal tax brackets for 1990 and 1991.




This new bracket follows the philosophy held by the Democrats of placing a greater tax burden on those with higher taxable incomes and reducing the hardship felt by those with lower incomes.

Luxury Taxes and the Alternative Minimum Tax

In addition to the new bracket, luxury taxes aimed at the rich have also been incorporated as a 10 percent surcharge. Automobiles costing over $30,000, including small trucks and vans, are covered, but it does not include vehicles used in business for transporting property or people. For furs, the threshold is $10,000, and boats and yachts over $100,000 are included. Airplanes with a price tag over $250,000 are taxed, unless they are used for certain legitimate business purposes ("Consumption" 5). Another tax affected is the alternative minimum tax. The tax rate will increase from 21 percent to 24 percent. However, things are not as bleak as they seem for the wealthy. To mitigate the damages, a cap has been placed on capital gains tax, freezing the rate at 28 percent instead of taking it up to the 31 percent level.

Limitation of Personal Exemptions

Other areas that will be affected in 1991 are that of personal exemptions and itemized deductions. A phase-out of personal exemptions and exemptions for dependents occurs when adjusted gross income exceeds:

| | |
|---|---|
| Single: | $100,000 |
| Married Filing Joint/Surviving Spouse | $150,000 |
| Head of Household | $125,000 |
| Married Filing Separately | $ 75,000 |

Exemptions are phased-out by 2 percent for each $2,500 that adjusted gross income (AGI) exceeds the above threshold amounts. For married filing separately, the phase-out is 2 percent for each $1,250.

**To calculate the exemption amount:**

1) AGI - Threshold amount = Excess amount

2) (Excess amount/$2500) x 2 = Phase-out percentage
*Round up to next whole percent, e.g. 12.6=13, 15.1=16

3) Phase-out percentage x Exemption amount = Amount of exemptions phased-out

4) Exemption amounts x Phase-out amount = Allowable exemption deduction

Source: Update for West's Federal Taxation, 1991 Editions

Phase-out of Itemized Deductions

A limitation has been placed on itemized deductions as well. A 3 percent floor on itemized deductions is incurred when AGI exceeds $100,000 ($50,000 for married filing separately). The reduction is applied after other applicable limitations such as the 2 percent floor on miscellaneous deductions. The reduction cannot exceed 80 percent of itemized deductions subject to the 3 percent limitation. Itemized deductions can be broken down into two types: Category A, those that are reduced by the 3% limitation, and Category B, those that are not affected. Category B deductions include medical expenses, investment interest (limited to net investment income), gambling losses (limited to gambling gains), and casualty and theft losses.

EXAMPLE: F and C, husband and wife, file a joint return. They have an AGI of $190,000. Their itemized deductions are as follows:

| CATEGORY A | | CATEGORY B | |
|---|---|---|---|
| State income taxes | $ 2,500 | Casualty loss | $ 2,500 |
| Mortgage interest | 8,000 | Investment interest | 900 |
| Real estate taxes | 700 | | $ 3,400 |
| Miscellaneous (after 2% of AGI) | 350 | | |
| | $11,550 | | |

1) Determine limitation:
$11,550 Category A deductions x 80% = $9,240

2) Determine 3% of the excess amount over threshold:
3% x ($190,000 - $100,000) = $2,700

3) Subtract from Category A deductions the lesser of the amounts determined in step 1 or 2.
$11,550 - $2,700 = $8,850

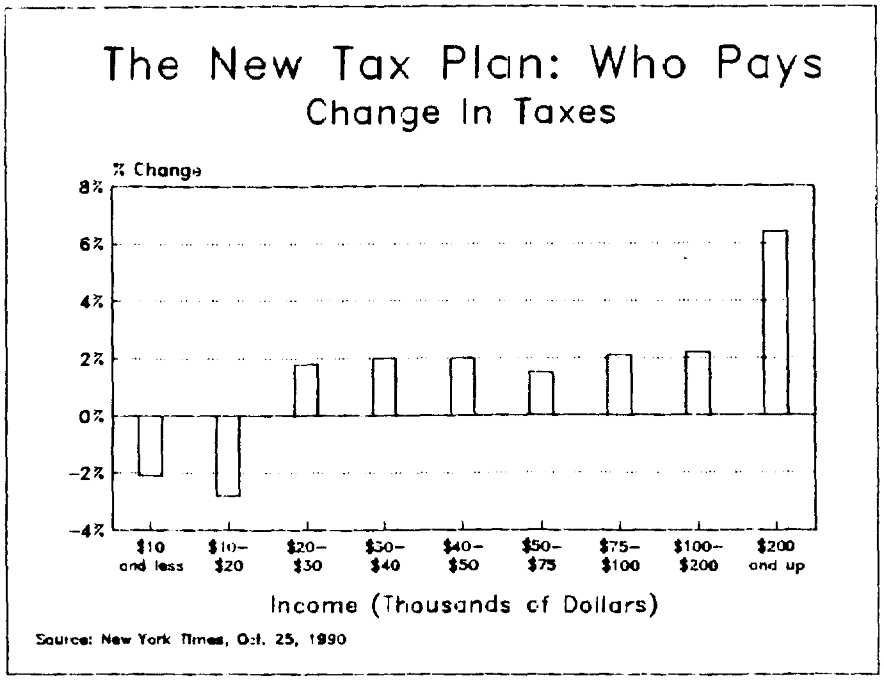
4) Add the amount determined in step 3 to the Category B deductions.
$8,850 + $3,400 = $12,250

Total itemized deductions are $12,250

Source: Update for West's Federal Taxation, 1991 Editions

Excise Taxes and Medicare

The wealthy are not the only ones who are going to feel the tax bite. Consumer products which are heavily consumed by lower to middle income families are also seeing a tax increase. A rise of 5 cents a gallon to 14 cents a gallon has been placed on gasoline. Items such as cigarettes and beer have been hit as well. For tobacco products, an increase of 25 percent was effective on January 1, 1991, and there is a 20 percent increase as of January 1, 1993. The tax will jump from 16 cents to 20 cents and then to 24 cents. For a person who smokes a pack of cigarettes a day, it means an additional $14.60 a year in taxes (Quinn 56). Wine saw the greatest increase from 3 cents per bottle to 21 cents. For distilled spirits, the tax goes from $12.50 to $13.50 a proof gallon. Beer sees its tax doubled from 16 cents to 32 cents a six-pack ("Consumption" 5). A beer drinker who consumes one can of beer a day will reduce the deficit by $9.49 per year (Quinn 56). The largest affect will be felt in the increase of income subject to taxation for medicare hospital insurance. The amount taxed will jump from $53,400 in 1990 to $125,000 for 1991, at the tax rate of 1.45 percent ("Summary" 12). The overall effect of the new changes in taxation for different income levels is illustrated by the graph on the following page. It depicts the percentage change in the amount of taxes paid by income groups.




<u>End of the Bubble?</u>

Now that the bubble has burst, the lawmakers have returned to a progressive form of taxation. Or have they? Bubbles are floating around in greater amounts in this new tax reform. To cover additional tax increases, bubbles have been put into place in itemized deductions, personal exemptions, and real estate losses. For itemized deductions, the bubble occurs when the phase-out begins at $100,000 of AGI. The exemption reduction begins at an AGI of $150,000 for those filing a joint return (McCormally 86). Wherever there is phase-out that is triggered by a certain level of adjusted gross income, a bubble is present. Some of the current bubbles are more inequitable than the 33 percent bracket bubble that has just been popped. In the case of personal exemption phase-out, the more exemptions that are claimed, the greater the bubble becomes. It lasts until the final exemption is phased-out. As a result, a family of 10 could pay up to 36 percent of its final earnings in taxes (Hershey A16).

## Tax Planning

The question that arises now is how to take advantage of these changes. Although it may look favorable at the present time to make early payments on tax consulting fees and other itemized deductions in 1990 to thwart the 3 percent reduction of certain 1991 deductions, it is not recommended. What is spent now may be needed in 1991 to clear the 2 percent floor on these miscellaneous items. The best place to focus is the alternative minimum tax or AMT. The rate will increase from 21 percent for 1990 to 24 percent in 1991. It might be wise to accelerate income recognition before the rate increase ("Coming Tax" 155). One final item to consider is personal interest expense. Interest paid on credit cards and automobile loans, for example, are completing their phase-out period in 1990. Ten percent of the interest expense paid is allowed as an itemized deduction. Taxpayers should take advantage of tax planning to ensure compliance with the new laws and to benefit from the changes that will occur between 1990 and 1991.

## Comparison of Four Tax Returns

**Case 1: Newton, Mass. Couple with two children.**

He is a radiologist at a health maintence organization, and she is a software engineer, each earning a salary of $125,000. They recently had a long-term capital gain of $10,000 by selling shares of I.B.M. stock. Under the new tax plan, they are eligible for $30,200 in itemized deductions for mortgage payments on their house, medical expenses, state and local income taxes and charitable contributions. But despite a number of tax write-offs, they and other families with incomes over $250,000 will see their taxes increase by hundreds of dollars, mainly as a result of the increase in Medicare taxes.

| | Present Law | New Plan |
|---|---|---|
| Adjusted gross income | $260,000 | $260,000 |
| Allowable itemized deductions | 35,000 | 30,200 |
| Four personal exemptions | 8,600 | 8,600 |
| Taxable income | 216,400 | 221,200 |
| Regular tax liability | 60,592 | 61,677 |
| Capital gains benefit | --- | (300) |
| Personal exemption phase-out | 2,280 | 2,346 |
| Income tax | 62,872 | 63,723 |
| FICA for medicare | 1,574 | 3,625 |
| Net tax increase | | $ 2,902 |

**Case 2: Los Angeles, California. Executive with wife and two children.**

He is the chief executive officer of a Fortune 500 company and has a wife and two children. They recently sold their second home for a capital gain of $100,000. Of all Americans, the tax increases are greatest for this family and others with incomes approaching or surpassing $1 million.

| | Present Law | New Plan |
|---|---|---|
| Adjusted gross income | $800,000 | $800,000 |
| Allowable itemized deductions | 225,000 | 204,200 |
| Four personal exemptions | 8,600 | 8,600 |
| Taxable income | 556,400 | 587,400 |
| Regular tax liability | 158,592 | 175,199 |
| Capital gains benefit | --- | (3,000) |
| Personal exemption phase-out | 2,406 | 2,666 |
| Income tax | 161,000 | 174,865 |
| FICA for medicare | 787 | 1,812 |
| Net tax increase | | $ 14,890 |

**Case 3: New York City, New York. Single investment banker**

A 28-year-old who received an M.B.A. two years ago, she owns a co-op apartment in New York City and gives generously to the United Way, museums, and other charities. Like most people with incomes over $100,000, she will be seeing an increase in her taxes, as the rate on those of highest income increases fron 28 to 31 percent.

| | Present Law | New Plan |
|---|---|---|
| Adjusted gross income | $125,000 | $125,000 |
| Allowable itemized deductions | 35,000 | 34,350 |
| Personal exemption | 2,150 | 2,150 |
| Taxable income | 87,850 | 88,600 |
| Regular tax liability | 23,869 | 23,332 |
| Personal exemption phase-out | | 134 |
| Income tax | 23,869 | 23,466 |
| FICA for medicare | 787 | 1,812 |
| Net tax increase | | $ 622 |

**Case 4: Chicago, Illinois. Couple with two children.**

The father works as a mechanic and earns about $40,000 a year. They rent an apartment in Chicago. They are representative of working people throughout the country whose income taxes will be unaffected by the new law.

| | Present Law | New Plan |
|---|---|---|
| Adjusted gross income | $ 40,000 | $ 40,000 |
| Standard deduction | 5,700 | 5,700 |
| Four personal exemptions | 8,600 | 8,600 |
| Taxable income | 25,700 | 25,700 |
| Income tax | 3,855 | 3,855 |
| FICA for medicare | 580 | 580 |
| No tax change | | |

Source: <u>New York Times</u>, October 28, 1990.

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